Supreme Court, U. S.
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No. 76-

IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

FRANK LYON COMPANY, *Petitioner,*

v.

THE UNITED STATES, *Respondent.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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Petitioner, Frank Lyon Company, prays that a writ of certiorari issue to review a judgment of the United States Court of Appeals for the Eighth Circuit reversing a judgment of the United States District Court for the District of Arkansas.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Eighth Circuit is not yet reported; it is set forth as Appendix B, *infra* pp. 15a-30a. The opinion of the District Court, as supplemented, is not reported; it is set forth as Appendix A, *infra* pp. 1a-14a.

JURISDICTION

The judgment below was entered on May 26, 1976 (Appendix C, *infra* p. 31a). On August 6, 1976, the Court of Appeals denied a timely petition for rehearing (Appendix D, *infra* pp. 32a-33a). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED

1. Whether the petitioner was entitled, as owner-lessor of a building to deduct on its Federal tax returns depreciation with respect to that building, and interest which it paid on loans on which it was liable.

2. Whether the court of appeals erred in setting aside the factual and legal judgment of the district court that the petitioner was entitled to the interest and depreciation deductions, on the basis of the court of appeals' own conclusion that the "cumulative effect" of otherwise ordinary lease features rendered the ownership interest of Lyon "too unsubstantial" to allow Lyon to claim depreciation and interest deductions.

STATUTE INVOLVED

Section 163(a) of the Internal Revenue Code provides:

> (a) General Rule—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

Section 167(a) of the Internal Revenue Code provides:

> (a) General Rule—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—
>
> (1) of property used in the trade or business, or
>
> (2) of property held for the production of income.

STATEMENT

This case arises out of the sale and leaseback of a bank building between Frank Lyon Company ("Lyon"—or petitioner) and Worthen Bank & Trust Company ("Worthen"), a bank located in Little Rock, Arkansas. The terms of that agreement were the result of arms-length bargaining between the parties, and the overall structure of the arrangement was dictated by federal and state banking regulations with which Worthen was bound to comply.

Worthen began to plan construction of a new multi-story bank and office building in 1965. Initially Worthen planned to finance, build, and own the project itself at a total cost of $9,000,000 for the site, the building, and an adjoining parking facility.

This initial plan was abandoned for two reasons.

(1) Worthen found itself unable to raise the necessary funds because of interest rate limitations imposed by state law; it had planned on a $5 million conventional mortgage and $4 million in debentures, but Arkansas law forbade Worthen (then a state bank) to pay more than six percent on debentures it might issue, and the bonds were not marketable at that rate.

(2) Federal Reserve Regulations required Reserve Board approval if the total investment in bank premises exceeded capital stock; the Reserve system indicated that they would not approve of

Worthen owning the $9 million facility, either directly or through a subsidiary, because Worthen's capital stock was only $4 million.

Worthen then sought to develop a method which would provide Worthen with the use of the building, satisfy the requirements of federal and state regulators, and attract the necessary capital. It was concluded that this could be accomplished by a sale of the building to an independent outside investor, and a leaseback of the building to Worthen for its occupancy and use.

The State Bank Department and the Federal Reserve System approved a proposal for the sale and leaseback of the projected building under which Worthen would retain control of the adjacent parking facility but would sell the bank building and land for $7,500,000 and lease it back from the buyer. The State Bank Department required that Worthen have an option to purchase the leased property at the end of the fifteenth year of the lease at a price set in the agreement, and the Federal Reserve System required that the bank building be owned by an independent third party.

A number of investors were interested in owning the building on this general basis and submitted proposals to Worthen. Lyon heard of the arrangement at this time and submitted its first proposal on October 30, 1967.[1]

Taking the most favorable elements of various bidders' proposals (including a suggestion by Eastman Dillon, Union Securities Co. that sale of the land under the bank be eliminated from the sale to simplify establishment of equitable option prices), Worthen prepared and submitted to the bidders a "Specification for Sale-Leaseback of Worthen Bank and Office Building." Anxious to acquire the building, Lyon proposed a reduction of rent of $21,000 per year for the first five years. Lyon's proposal was accepted by Worthen, and Lyon was approved as an acceptable borrower by First National City Bank (FNCB) and New York Life Insurance Company.[2]

[1] For competitive reasons, Worthen desired to get the building in operation as soon as possible and it had begun construction on a cost-plus basis on September 15, 1967, before the buyer was chosen.

Final negotiations on terms began in December 1967 and were not completed until May 1968. Intensive discussions about all terms of the arrangement were carried on between Lyon and Worthen, with FNCB and New York Life participating on the financing issues. When the negotiations concluded, FNCB and New York Life required that the final terms be submitted to State and Federal Bank regulators for final approval. The regulators approved the terms.

Under the agreement, Worthen gave Lyon a ground lease for 76 years and 7 months on the site of the bank building, and sold the building to Lyon piece by piece, as it was completed,[3] for a total price of $7,640,000.

[2] FNCB's commitment letter stated the explicit understanding that "an acceptable real estate company" (Lyon) would be "the actual borrower" and that Worthen Bank "will not actually be guaranteeing our loan." The commitment letter of New York Life Insurance Company was addressed to Lyon.

[3] This arrangement was made because purchase of materials by the bank (by then a national bank) was not subject to Arkansas sales tax, pursuant to this Court's decision in *First Agricultural National Bank* v. *State Tax Commission*, 392 U.S. 339 (1968); and sale of the building elements to Lyon was not subject to sales tax, since it was a sale of real estate. The Federal Reserve System would not permit Worthen to complete the building and then sell it to Lyon because Worthen's investment in bank premises could at no time, however short, exceed its capital stock.

Lyon then leased the building back to Worthen for a primary term of twenty-five years with options to extend the lease for eight additional five-year terms.[4] To cover the purchase price, Lyon invested $500,000 out of its own working capital and $7,140,000 which it borrowed from New York Life on the permanent loan. At the end of the 11th, 15th, 20th and 25th years of the lease, Worthen had the option to purchase the building at prices agreed on in the lease.[5]

The lease was a "net lease," under which Worthen was charged with the responsibility for operating the building, for insurance and repairs, and for keeping the premises "in good order and condition: except for reasonable wear and tear."

In December 1969, Worthen took possession. On Lyon's 1969 tax return, Lyon accrued one month's rent in income and deducted one month's depreciation, and interest on the building. The Commissioner audited Lyon's return and determined without explanation

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[4] The rent schedule for the building was as follows:

First 11 years of the lease	$582,224
Years 11-25	613,156
Option Periods (Years 26-65)	300,000

The ground rents to be paid to Worthen by Lyon were $50.00 per year for the first 26 years 7 months and thereafter:

12/1/94 thru 11/30/99 (5 years)	$100,000
12/1/99 thru 11/30/04 (5 years)	150,000
12/1/04 thru 11/30/09 (5 years)	200,000
12/1/09 thru 11/30/34 (25 years)	250,000
12/1/34 thru 11/30/44 (10 years)	10,000

[5] The option schedule was as follows:

11/30/80 (after 11 years)	$6,325,169.85
11/30/84 (after 15 years)	5,432,607.32
11/30/89 (after 20 years)	4,187,328.04
11/30/94 (after 25 years)	2,145,935.00

that Lyon "is not the owner for tax purposes of any part of the Worthen Building," disallowed Lyon's depreciation and interest deductions, and adjusted Lyon's income accordingly.

Lyon paid the resulting deficiency. After a refund claim was disallowed, Lyon brought suit in the United States District Court for the Eastern District of Arkansas.

The district court held that the petitioner's depreciation and interest deductions were allowable. The court concluded that the legal intent of the parties had been to create a bona fide sale and leaseback, and that the arrangement substantively achieved this goal. The court rejected the notion that Worthen was acquiring an equity in the building through its rental payments, finding that the rents were reasonable throughout the period of the lease, and that the substantial option prices, negotiated at arms-length between the parties, represented fair estimates of market value at the applicable dates; the court concluded that it was highly unlikely as a practical matter that any purchase option would ever be exercised (App. 2a, 6a).

In light of the bid competition for ownership, the district court rejected any negative inference to be drawn from the fact that the rentals (or rentals combined with options) were only enough to amortize the New York Life loan and to pay Lyon a six percent return on its equity investment, on the assumption that the options would be exercised, contrary to the court's finding. (App. 13a, 10a.) Likewise the court rejected any inference built on the fact that it was a "net" lease which, the court noted, is a common form of long-term real estate lease (App. 13a, 12a).

Despite these clear findings, the court below reversed the decision of the district court. In its analysis, the court of appeals likened ownership for tax purposes to a "bundle of sticks" which represent the various benefits and burdens associated with ownership. The court focused on its perception (an erroneous perception, as we show below; see pp. 15-16, *infra*) that the agreement deprived Lyon of any prospect of realizing appreciation on its ownership through increased rentals, or sale to third parties, or condemnation, and left Worthen with effective control over the operation and disposition of the property—through the sixty-five years of the lease terms, including options, and beyond through its control of the underlying property. The court undertook its own evaluation of the facts, and adopted the conclusion that "the taxpayer [Lyon] totes an empty bundle" of ownership sticks, i.e., that Lyon's ownership interest was too insubstantial to support the claimed depreciation, despite the fact that Lyon retained all the risks and benefits if the options were not exercised, or if Worthen should become insolvent. Without much consideration, the court also disallowed the interest deductions on the same general basis.

REASONS FOR GRANTING THE WRIT

1. The arrangement in this case was a realistic one, made by the parties on an arms-length basis, and to meet legal requirements. Yet the court of appeals strikes it down on a retrospective determination that the taxpayer had no "significant ownership interest" (App. 30a) in the building. This decision is fundamentally in conflict with the decisions of the Court of Appeals for the Fourth Circuit in *American Realty Trust* v. *United States*, 498 F.2d 1194 (1974), where, on a similar set of facts involving a sale and leaseback, the court

held that the conclusions of the trier of the fact should be sustained, and with the decision of the Court of Appeals for the Ninth Circuit in *Cubic Corporation* v. *United States*, decided August 20, 1976, where the court likewise upheld a sale-leaseback, saying: "That the intent of the parties was to provide a legal means by which the counties [lessees] *could eventually* acquire title does not change a clear lease-option agreement into a contract of conditional sale." (Emphasis in original.)

Here, the petitioner, Lyon, a wholly independent company, was brought into the situation in order "to provide a legal means by which" Worthen could obtain the use of the building—using the words of the court in the *Cubic Corporation* case. The transaction necessitated ownership by Lyon, because Worthen could not legally own the building, and could not legally borrow the money needed for the construction of the building. Lyon made no loan to Worthen, and Worthen was not liable to Lyon, except for rent. For the court below to say that nevertheless Worthen was the owner of the building, and the borrower of the money, is to stand the transaction on its head, making it be something it could not be, and is contrary to the essence of this Court's decision in *Commissioner* v. *First Security Bank of Utah*, 405 U.S. 394 (1972).[6]

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[6] In the *First Security Bank of Utah* case, the Commissioner attempted to allocate to the Utah bank certain commissions on insurance. This Court held the allocation invalid because banks could not legally earn or retain such income under banking law. Similarly, here the Government argues that Worthen owns the building and should take the depreciation although bank authorities have demanded that Worthen not own the property and have confirmed that Worthen does not own it under this arrangement. The situation with respect to the interest deduction is similar, since Worthen could not legally borrow the money, and yet is treated by the court below as the borrower.

2. The Government will doubtless say that there is no conflict because all cases in this area have their own facts, and so any decision may be distinguished on one ground or another. But this overlooks the important role of this Court in providing guidance and clarification to the lower courts, and to lawyers and government officials who are engaged in the administration of the tax laws. It is an appropriate function of this Court to provide such guidance on matters of basic principle in areas which are constantly recurring in tax administration and in the courts. This is especially true where the question is one of importance on which businessmen and lawyers need light in order that they may intelligently plan and carry out transactions on a basis of reasonable assurance without the inevitability of controversy and litigation with respect to each transaction.

Sale and leaseback arrangements have been widely used, and, as here, in many situations which do not involve any aspect of "sham" or "tax avoidance."[7] In this case, for example, there is no doubt that depreciation was sustained, and that interest was paid. The understanding that these items could be deducted by Lyon was a basis on which the negotiations between Lyon and Worthen were conducted. It made little or no difference to the Government which entity took the

[7] Cases involving *gift* leasebacks, often in intra-family situations, present a much greater danger of tax avoidance and wholly different policy considerations. *Cf. Van Zandt* v. *Commissioner*, 341 F.2d 440 (5th Cir. 1965). Here the transaction is a commercial one bargained out at arms-length, and the parties are subject to identical tax rates, so there is no effort to take advantage of a tax differential.

deduction as long as there was no double deduction.[8] If it had been known that these items were deductible by Worthen (which is the consequence of the decision below; see *Helvering* v. *Lazarus & Co.*, 308 U.S. 252 (1939)), the rental payments would have been adjusted accordingly. To deny these deductions now is to catch Lyon in a trap, and to give Worthen a windfall; the bargain which the parties made is scrambled without any substantive justification.

Typically, the sums involved in sale-and-leasebacks are substantial, and the complexity and variations of sale-leaseback arrangements reflect the fact that such transactions are devised to meet specific situations. Flexibility of form is an important part of the utility of the device, but uncertainty has often been the result. In the absence of a clearly understandable rule as to the tax consequences, the courts have seized on various mutually exclusive factors as determinative of tax treatment. A list of some of the cases which were cited by both the Government and the taxpayer below in

[8] There is no doubt that Lyon "sustained" depreciation. Under the lease, Worthen's obligation to maintain and repair the building, and its obligation to provide insurance, explicitly excluded "reasonable wear and tear," which is the statutory definition of depreciation under Section 167(a) of the Internal Revenue Code. The building gets older year by year, and Lyon sustains this loss unless Worthen exercises one of its options to buy the building. Yet the district court found explicitly that it was unlikely that Worthen would exercise its options (App. 2a, 6a).

Moreover, Lyon takes the risk of Worthen's continued solvency. In the event that Worthen could not make payments under the lease, Lyon would remain the owner of the building and have only the building to look to. This clearly shows that it is Lyon that sustains the depreciation. The fact that it receives rental payments in whatever amount, is irrelevant on the depreciation issue.

support of their contrary characterizations of the arrangement at issue in this case is given below.[9] The Internal Revenue Service has also wrestled with the problem inconclusively on a number of occasions. *Rev. Rul.* 55-540, 1955-2 C.B. 39; *Rev. Rul.* 68-590, 1968-2 C.B. 66; *Rev. Proc.* 75-21, 1975-1 C.B. 715; *Rev. Proc.* 75-28, 1975-1 C.B. 752.[10]

The consequence of the decision below—striking down a bona fide, arms-length transaction, involving no tax avoidance or sham—is to leave chaos in this area of tax law, calling out for this Court to provide oversight and guidance.

After a substantial number of lower court decisions have been made in a field like this, so that the area is "mature", it is appropriate for this Court to resolve the basic issues which have developed. Borrowing a phrase from another field, the failure to grant review in the face of a conflict in approach as sharp as that between the court below and that of the Fourth Circuit in *American Realty Trust*, and of the Ninth Circuit in *Cubic Corporation*, would be to leave the issues "capable of repetition, yet evading review". *Pacific Terminal Co.* v. *Interstate Commerce Commission*, 219 U.S. 498, 515 (1911).

[9] *American Realty Trust* v. *United States*, 498 F.2d 1194 (4th Cir., 1974); *Meiselman* v. *Commissioner*, 309 F.2d 666 (4th Cir., 1962); *Western Contracting Corporation* v. *Commissioner*, 271 F.2d 694 (8th Cir. 1959); *Breece Veneer and Panel Co.* v. *Commissioner*, 232 F.2d 319 (7th Cir. 1956); *Oesterreich* v. *Commissioner*, 226 F.2d 798 (9th Cir. 1955); *Benton* v. *Commissioner*, 197 F.2d 745 (5th Cir. 1952); *Arkansas Bank and Trust Company* v. *United States*, 224 F. Supp. 171 (W.D. Ark. 1963); *Kearney & Trecker Company* v. *United States*, 195 F. Supp. 158 (E.D. Wis. 1961); and *Reade Manufacturing Company* v. *Commissioner*, 32 TCM 1225 (1973).

[10] *Rev. Proc.* 75-21 met with strong protest from the real estate industry. The Service indicated that Rev. Proc. 75-21 would not be generally applied to real property, but that "some if not many of the ruling guidelines should be applicable." See Rosenberg and Weinstein, "Sale-Leasebacks: An Analysis of These Transactions after the Lyon Decision," 45 Journal of Taxation 146, 147 n.1 (1976) (the authors characterize both the *Lyon* court and the IRS as "groping for guidelines").

The situation is comparable to that which existed in the field of short term trusts when this Court granted certiorari, and decided *Helvering* v. *Clifford*, 309 U.S. 331 (1940), and in the field of family partnerships, when this Court granted certiorari, and decided *Commissioner* v. *Culbertson*, 337 U.S. 733 (1949). In each of these instances, after this Court clarified the basic principles, the decisions of this Court were followed by legislation by Congress, and there has been very little litigation or administrative controversy in either field ever since. In the absence of a clarifying decision by this Court, multiplication of litigation in the lower courts is inevitable, and apparently haphazard frustration of careful plans can be expected to continue.

This Court should grant review now in order to clarify the law and thus to facilitate bona fide tax planning in this area by businessmen and their counsel. An arrangement involving large sums of money and extending over a long period of time cannot be prudently planned on mere speculation as to how some future court will assess the allocation of interests which the parties have chosen.[11]

[11] That there is no substantial risk to the Government here is shown by the provision of Section 48(d) of the Internal Revenue Code, which expressly allows a lessor to pass on the investment credit to the lessee, as the parties may agree. As the Tax Court, and the Courts of Appeals for the Ninth and Tenth Circuits have indicated, investment credit and depreciation involve very similar questions of "ownership" from the viewpoint of tax policy. See *Northwest Acceptance Corporation*, 58 T.C. 836 (1972), *aff'd* 500 F.2d 1222 (9th Cir. 1974); *Lockhart Leasing Company* v. *United States*, 446 F.2d 269 (10th Cir. 1971), *affirming* 54 T.C. 301 (1970).

3. In its decision denying Lyon a deduction for interest paid, the court below has reached a result that is so clearly erroneous that it departs from customary standards in the administration of justice and calls for correction by this Court. Section 163 of the Internal Revenue Code specifically allows a deduction for "all interest paid or accrued within the taxable year on indebtedness". There is no dispute that Lyon borrowed money from First National City Bank and from New York Life Insurance Company, and paid interest on both loans. Lyon was the only borrower. Worthen was not liable on the loans; it could not legally undertake the loans. Worthen did not owe interest, and did not pay any interest. Whatever may be the merit of the "bundle of sticks" argument, and whatever may be the appropriate evaluation of the ownership interests in the property, there is no doubt on this record that Lyon was liable on the loans, and that it paid interest which it owed, and for which Worthen was not liable, and could not legally be liable. Worthen was under no obligation either to pay interest or to reimburse Lyon.

The action of the court below in denying the interest deduction cannot be justified on any theory, and should be summarily corrected. The effect of the decision of the court below on this question is to highlight the error in its decision on the depreciation question, and to emphasize the importance of a clarifying opinion by this Court on the basic problems involved in this case.

4. The decision below, in its treatment of the findings made by the district court, as trier of the facts, is contrary to this Court's decision in *Commissioner* v. *Duberstein*, 363 U.S. 278 (1960).

In the present case, the trial court found that the rents were reasonable throughout the period of the

lease (App. 13a, 5a-6a), and rejected the notion that Worthen was acquiring an equity in the building through its rental payments. (App. 2a, n.2.) The trial court also found that the substantial option prices, negotiated at arms-length between the parties, represented fair estimates of market value at the applicable dates. (App. 6a). The trial court further concluded that it was highly unlikely as a practical matter that any purchase option would ever be exercised. (App. 2a, n.2.) Finally, the trial court made the ultimate finding that this was in fact a sale and leaseback. Specifically, the Court said (App. 1a-2a):

> "After having heard the evidence and the arguments and after having read the excellent briefs filed by the parties, the Court finds that it was the intention of the parties, as evidenced by their written agreements, read in the light of the attending facts and circumstances existing at the time the agreement was executed, that the transaction be exactly what the language and form of the transaction indicate, that is, a sale-leaseback with option to repurchase. This was both the "subjective" intent of the parties, and it is also the "objective" intent as expressed by the clear, unambiguous language of the written instruments involved. The Court also finds and concludes that, objectively, the transaction was in substance, as well as in form, a sale-leaseback with option to repurchase. Any other view of the case would not only bring strange and untenable results but would be both unjust and contrary to the intent and purpose of our tax laws."

The dangers of the approach taken by the court of appeals, in itself undertaking to determine the facts—through its process of appraising the "bundle of sticks"—is clearly shown by its factually erroneous conclusion that the agreement here deprived Lyon of any prospect

of realizing appreciation on the property. In the first place, Lyon's basis for the property would be reduced by depreciation allowed, so that there would be appreciation, taxable to Lyon, if the options were exercised.

Moreover, the court has misapprehended at least three important factors in the situation:

> (1) Lyon has had a number of offers from other investors to purchase the building at a profit to Lyon, which offers were refused, not because of any restrictions in the agreements on the petitioner's right to sell, but because the petitioner thought it had a good investment. (11-R 378; Pltf. Ex. 51).
>
> (2) While it is true that Worthen will realize the appreciation, if any, in the value of the building in the event of *total* destruction *after* December 1, 1980, under the agreements it is Lyon rather than Worthen which will realize the appreciation in the event of *total* destruction or taking prior to December 1, 1980, and in the event of partial damage or partial condemnation at any time.
>
> (3) Worthen did not control the disposition of the property for 65 years through its various options and thereafter through its ownership of the land. The petitioner's retention of control of the building for ten years after the expiration of the building lease and at a fixed ground rent of only $10,000 per year was an important ownership interest not controlled by Worthen, and Worthen's alleged ownership of the building on the expiration of the 75-year ground lease is highly questionable under Arkansas law. See *Stirman* v. *Cravens*, 33 Ark. 376 (1878).

The petitioner does not ask this Court to evaluate these facts. It does contend that the court of appeals erred when it undertook to reexamine the facts which had been determined by the district court. The action of the court of appeals flies in the face of Rule 52(a) of the Rules of Civil Procedure which provides that:

> Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses.

As Judge Brown said in *Horton* v. *U. S. Steel Corp.*, 286 F.2d 710, 713 (5th Cir. 1961), the findings "come here well armed with the buckler and shield of F.R. Civ. P. 52(a)." Nor should Rule 52(a) "be construed to encourage appeals that are based on the hope that the appellate court will second-guess the trial court." *Lundgren* v. *Freeman*, 307 F.2d 104, 114 (9th Cir. 1962).[12] The findings of the district court should not have been re-evaluated by the court below.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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November, 1976

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[12] Judge Duniway, speaking for the court in *Lundgren*, made it clear that the impact of Rule 52(a) applies to cases tried on the basis of documentary evidence as well as on issues of credibility, 307 F.2d at 113-115.

APPENDIX

APPENDIX A

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF ARKANSAS
WESTERN DIVISION

No. LR-73-C-247

FRANK LYON COMPANY, *Plaintiff*

v.

UNITED STATES OF AMERICA, *Defendant*

June 11, 1975. Year 1969.

EISELE, *Chief Judge:*

Memorandum Letter Opinion

Gentlemen:

Circumstances will not permit the Court to file an elaborate memorandum supplementing the findings and conclusions that it made in open court at the conclusion of the trial. Nor is an elaborate memorandum necessary in this case.

There are no true factual issues remaining, and the parties are in general agreement as to the applicable law. They do disagree with respect to the inferences to be properly drawn from the evidence and have different opinions as to the application of the legal principals involved.

The Government contends that although the "form" of the transaction was a sale and leaseback arrangement, the "substance" amounted to a nonrecourse loan for federal tax purposes. The plaintiff, on the contrary, asserts that the transaction, for federal tax purposes, was in "substance" exactly what it was in "form", that is, a sale-leaseback.

After having heard the evidence and the arguments and after having read the excellent briefs filed by the parties, the Court finds that it was the intention of the parties, as evidenced by their written agreements, read in the light of the attending facts and circumstances existing at the time

the agreement was executed, that the transaction be exactly what the language and form of the transaction indicate, that is, a sale-leaseback with option to repurchase. This was both the "subjective" intent of the parties, and it is also the "objective" intent as expressed by the clear, unambiguous language of the written instruments involved. The Court also finds and concludes that, objectively, the transaction was in substance, as well as in form, a sale-leaseback with option to repurchase. Any other view of the case would not only bring strange and untenable results but would be both unjust and contrary to the intent and purpose of our tax laws.

The defendant concedes that Worthen turned to the sale-leaseback arrangement because of the net capital requirements of the Federal Reserve Board. See footnote, page 1, Defendant's Supplemental Memorandum of Fact and Law, filed December 20, 1974. It is likewise clear from the evidence that Worthen was going with such an arrangement, one way or the other, before the plaintiff entered the picture.[1]

The theory of the defendant that the plaintiff "loaned" Worthen $500,000 is completely untenable, both in fact and law, as indicated by the Court at the conclusion of the trial. As there stated, it is most unlikely that Worthen will exercise the option at the end of eleven years, or, indeed, at the end of any subsequent option period.[2] Absent action by

[1] The Court senses that a controversy might not have arisen at all had Worthen concluded the same, identical, transaction with parties other than the plaintiff. The close relationship between the plaintiff and Worthen appears to have made a great impression upon Mr. Charles Richardson, the agent who wrote the report which started this case on its way to this Court.

[2] Worthen's future capital requirements and the option prices stipulated on the one hand and the reasonable rentals stipulated on the other make this quite clear. Because of the unlikelihood, the improbability, that the option will be exercised, there is no basis to the Government's contention that it is acquiring an equity in the property through its payment of rent.

Worthen, there is no way that plaintiff can obtain repayment of the so-called "loan".

Plaintiff holds the legal title to the building under Arkansas law and is for tax purposes, too, the owner thereof. It bears the burden of depreciation and obsolescence.

The defendant does not contest the unreasonableness of the rental charge for the building. The Court has already indicated in open court that the reasonableness of the annual rent under the ground lease was really immaterial because under the arrangement it was essentially a wash-out item.

The plaintiff had mixed motivations for wanting to enter into the transaction, in addition to receiving the benefits of the tax shelter involved: in addition to the good after-tax rate, the plaintiff had a need to diversify its holdings and a need to use its accumulated earnings. There was also the long-term return on the investment which could be expected when the mortgage indebtedness was retired.

At this time I direct the attorney for the plaintiff to prepare and submit to the defendant, for its approval as to form, a precedent judgment in conformity with this letter-memorandum and the factual findings and legal conclusions stated in open court at the conclusion of the case. The Court will also *consider* making additional factual findings and conclusions of law upon the request of either party if requests therefor are received by May 30, 1975. The precedent judgment shall be submitted by June 4, 1975.

PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW

Findings of Fact

1. During 1965, Worthen Bank & Trust Company ("Worthen") began to plan the construction of a new multistory bank and office building to replace its old bank building in Little Rock, Arkansas. About the same time Union National Bank of Little Rock ("Union") also began to plan the construction of a new bank and office building.

Adjacent sites were acquired by both banks on Capitol Avenue, separated only by Spring Street. It became a matter of competition and prestige between the two banks as to which bank would start and complete its building first.

2. Worthen initially planned to finance the estimated $9,000,000 cost of its site, new building and parking facility by selling $4,000,000 of debentures and using the proceeds to purchase $4,000,000 of capital stock of a wholly owned real estate subsidiary, which would then raise the remaining $5,000,000 through a conventional mortgage loan on the new premises. This plan was abandoned for two reasons. As a bank chartered under the laws of Arkansas, Worthen could not pay more than the then statutory limit of 6% on any debentures it might issue, and Worthen was unable to locate a purchaser of the proposed $4,000,000 of debentures at an interest rate of 6% or less. Further, under the provisions of Section 24A of the Federal Reserve Act, prior approval of the Board of Governors of the Federal Reserve System was required if the total investment in bank premises (including any investment in a real estate company holding title to the premises) exceeded Worthen's capital stock of $4,000,000, and Worthen was informed by staff employees of the Federal Reserve System that they would not recommend approval of the plan by the Board of Governors.

3. Worthen then proposed a new plan involving a sale and leaseback. Both the Federal Reserve Bank of St. Louis and the State Bank Department approved the new plan after required modifications, including a requirement by the State Bank Department that Worthen have an option to repurchase the building after 15 years. Thereafter Worthen conducted detailed negotiations with several investors, including Goldman, Sachs & Co., Eastman Dillon, Union Securities & Co., Stephens, Inc. and plaintiff, resulting in the preparation by Worthen of a "Specification for

Sale—Leaseback of Worthen Bank and Office Building", which incorporated the best features from Worthen's point of view of the proposals made by the various investors. These specifications were submitted to Stephens, Inc. and plaintiff, the two best bidders, and the proposal of plaintiff was accepted when plaintiff improved its bid by reducing the proposed rent $21,000 per year for the first 5 years.

4. Because of its race with Union to complete construction first and prior to the selection of the investor, Worthen obtained a verbal commitment from First National City Bank for interim financing and from New York Life Insurance Company for permanent financing, subject to the lenders' approval of the investor to be selected. Worthen also negotiated a cost-plus construction contract with the general contractors prior to the final selection of the investor. After plaintiff was selected as the investor, plaintiff, Worthen, New York Life and First National City Bank spent five months in hard arm's length negotiations and drafting before finalizing the documents reflecting the agreements between the parties.

5. Worthen leased to plaintiff for 76 years and 7 months the ground under the bank building, sold the building piecemeal to plaintiff for $7,640,000 as it was being constructed (to meet the requirement of the Federal Reserve Bank that the building not appear on Worthen's books), and then leased back from plaintiff the completed building for a primary term of 25 years, with options to extend the lease for 8 additional terms of 5 years. Plaintiff invested in the building $500,000 from its own working capital and $7,140,000 it borrowed from New York Life Insurance Company on the permanent loan.

6. The annual rent of $582,224 for the first 11 years of the building lease and $613,156 for the next 14 years is the exact amount required to amortize the New York Life loan during the 25-year primary term of the lease. The

rent on the building during the option periods totaling 40 years is $300,000 per year. The evidence reflected, and the Court finds, that the rent to be paid by Worthen during the term of the lease is reasonable, a fact not contested by the defendant.

7. Worthen was given the option to purchase the Worthen Building on the following dates at the following purchase prices:

11-30-80 (after 11 years)	$6,325,169.85
11-30-84 (after 15 years)	5,432,607.32
11-30-89 (after 20 years)	4,187,328.04
11-30-94 (after 25 years)	2,145,935.00

The option price at each date represents the unpaid balance of the New York Life note plus plaintiff's $500,000 plus 6% compounded interest. It also represents the negotiated estimate of plaintiff and Worthen as to the fair market value of the building on the option dates, which the Court finds to be reasonable. The defendant produced no witnesses to contest the reasonableness of the option prices.

8. There has never been any understanding or agreement between Worthen and plaintiff that Worthen will ever exercise any of its options to purchase. Because of Worthen's future capital requirements, the very substantial amounts of the option prices, the reasonableness of the net rents Worthen will be required to pay during the original and extended terms of the building lease and the economic return Worthen earns on its funds not invested in real estate, it is most unlikely and improbable that Worthen will exercise its option to purchase at the end of the first eleven years of the lease or at the end of any of the subsequent option periods.

9. The ground lease requires plaintiff to pay Worthen $50.00 per year for the first 26 years, 7 months (the length of the primary term of the building lease plus the construc-

tion period). Thereafter the annual rental under the ground lease will be as follows:

12-1-94 thru 11-30-99 (5 years)	$100,000.00
12-1-99 thru 11-30-04 (5 years)	150,000.00
12-1-04 thru 11-30-09 (5 years)	200,000.00
12-1-09 thru 11-30-34 (25 years)	250,000.00
12-1-34 thru 11-30-44 (10 years)	10,000.00

The government contends that the ground rent of $50.00 per year during the primary term of the building lease is unreasonably low and indicates that Worthen owns the building. The evidence clearly showed, and the Court finds, that the amount of the ground rent during the first 25 years of the building lease is immaterial: had the ground rent to be paid by plaintiff to Worthen been increased, the building rent to be paid by Worthen to plaintiff would have been increased by the same amount, resulting in a washout.

10. On an audit of plaintiff's income tax return for 1969, the Commissioner of Internal Revenue determined, without further explanation, that plaintiff is "not the owner for tax purposes of any portion of the Worthen Building. Therefore, the income and expenses related to this building are not allowable to you for Federal income tax purposes." Based upon this determination the Commissioner made the following adjustments to plaintiff's reported income:

1. Accrued rental income for 1 month from Worthen	$(48,527.01)
2. Accrued interest for 1 month owed to New York Life	40,162.50
3. Depreciation for 1 month on Worthen Building	51,618.79

4. Expenses during construction:

(a) Interest paid to FNCB .	$403,899.54	
(b) Legal expense	33,351.05	
(c) Title insurance	10,140.00	
(d) Audit expense	3,475.00	
(e) Telephone and travel ..	801.16	451,666.75
5. Accrued interest income		2,298.15
Total increase in reported income		$497,219.18

11. Based upon these determinations, the Commissioner assessed an income tax deficiency against plaintiff in the amount of $236,596.36, together with interest in the amount of $43,790.84, making a total deficiency assessment of $280,387.80. (This figure does not include other uncontested adjustments which are not involved in this case). Plaintiff paid the deficiency assessment and filed a claim for refund of the $280,387.20, which claim the Commissioner disallowed. Thereafter plaintiff filed this action to recover the $280,387.20, with interest.

12. The Government contends that, although the "form" of the transaction was a sale and leaseback arrangement, in "substance" Worthen owned the building; that plaintiff was a mere "conduit" of the interim loan from First National City Bank to Worthen and of the permanent loan from New York Life Insurance Company to Worthen; and that plaintiff "loaned" to Worthen the $500,000 which plaintiff invested in the building from its own working capital.

13. The plaintiff contends that for federal tax purposes the transaction was in "substance" exactly what it was in "form", i.e., a true sale and leaseback transaction, with the interim and permanent loans being in form and substance made to plaintiff rather than to Worthen.

Conclusions of Law

1. It was both the "subjective" and "objective" intention of the parties, as evidenced by their written agreements when read in the light of the attending facts and circumstances existing at the time the agreements were executed, that the transaction be a sale-leaseback with options to repurchase, exactly in accordance with the form and language of the documents evidencing the transactions. Any other view of the case would not only produce strange and untenable results but would be both unjust to plaintiff and contrary to the intent and purposes of the applicable federal tax laws. Western Contracting Corporation v. Commissioner, 271 F.2d 694 (8 Cir. 1959); Arkansas Bank and Trust Company v. United States, 224 F.Supp. 171 (D.C. Ark. 1963).

2. Plaintiff owns the Worthen Building, both under Arkansas law and for federal income tax purposes. Because of the improbability that plaintiff will exercise any of its options to purchase, there is no basis for the defendant's contention that Worthen is acquiring an equity in the property through the payment of rent. Since the parties in good faith actually intended to enter into a sale-leaseback transaction, Worthen will acquire an equity in the property only if and when it ever exercises any of its options to purchase. Until the option to purchase is exercised, plaintiff bears the burden of the depreciation and obsolescence of the building. Defendant did not question the method or rate of depreciation used by plaintiff. Plaintiff is entitled to deduct the depreciation claimed on the building in its 1969 return. Breece Veneer and Panel Company v. Commissioner, 232 F.2d 319 (7 Cir. 1956); Benton v. Commissioner, 197 F.2d 745 (5 Cir. 1952); Kearney & Trecker Company v. United States, 195 F.Supp. 158 (E.D. Wisc. 1961).

3. Plaintiff was not a mere "conduit" for loans to Worthen by First National City Bank and New York Life

Insurance Company, as contended by the defendant. Plaintiff was the borrower and sole obligor on the interim loan and on the permanent loan. The interim and permanent lenders made independent investigations of plaintiff's financial stability, negotiated with plaintiff for almost six months over the details of the loans and in all respects intended and treated plaintiff as the borrower. The fact that Worthen negotiated tentative commitments for the loans prior to the selection of plaintiff as the investor does not indicate that Worthen was the borrower; it simply enabled Worthen to attract more potential investors and to obtain a lower rent. The fact that the rents were no less than the amount required to amortize the permanent loan was a requirement of New York Life Insurance Company; the fact that the rents were no more is only a reflection of the relatively small initial equity required of the investor and of the intensity of the competition among the potential investors for the investment. Plaintiff is entitled to deduct the interest paid and accrued on the interim and permanent loans.

4. Plaintiff is entitled to allocate and deduct its expenses incurred in obtaining the interim loan and permanent loan over the lives of the respective loans to which they relate. Detroit Consolidated Theatres, Inc. v. Commissioner, 133 F.2d 200 (6 Cir. 1943); Anover Realty Corp., 33 T.C. 671 (1960). Plaintiff is entitled to allocate and deduct over the life of the building the expenses incurred in acquiring the building. Plaintiff and defendant have stipulated the proper allocation of such expenses.

5. Even if the Court had found that Worthen owned the building for federal income tax purposes and was entitled to the depreciation deduction, plaintiff would still have been entitled to deduct the interest it paid on the interim and permanent loans and to allocate and deduct the expense it incurred in obtaining the interim and permanent loans and title to the building. Rev.Rul. 72-543.

6. The theory of the defendant that plaintiff "loaned" $500,000 to Worthen is completely untenable, both in fact and in law. There was no obligation or agreement by Worthen to repay the $500,000 and no way plaintiff could force the repayment. The only way plaintiff could ever receive the $500,000 from Worthen would be through the exercise by Worthen of one of its options to repurchase, an event entirely within the discretion of Worthen and highly improbable. Consequently, the Commissioner erred in assuming that Worthen will exercise its option at the end of the eleventh year of the building lease, and in determining that plaintiff's anticipated $303,356 gain on the assumed exercise of the option is the equivalent of interest which plaintiff must accrue as income evenly over the first eleven years of the lease. Regulations 1.446-1(c)(ii).

7. The defendant placed considerable emphasis upon the fact that, assuming plaintiff exercised its option to purchase at the end of the first eleven years of the lease, plaintiff's deduction for depreciation on the building would generate an operating loss deductible against other income of the plaintiff which would result in the net tax saving to plaintiff of $312,220.45 over the eleven year period. (Defendant's Exhibit 6). Defendant argued that plaintiff's only reason for investing in the building was to obtain this tax saving, and that a device to minimize tax liability, with no additional business purpose, will be disregarded for tax purposes. Defendant's argument on this point is in error for several reasons. First, the evidence clearly reflects, and the Court finds, that plaintiff was motivated to enter into the transaction, not only because of the good current after-tax return offered by the investment, but because of plaintiff's need to diversify its holdings, the need to use its accumulated earnings to avoid a Section 531 tax, and the anticipated long-term return on the investment after the permanent loan was retired. Secondly, the form of the transaction was determined by Worthen within guidelines

established by banking law restrictions having nothing to do with tax motives; substantially the same terms had been negotiated with other potential investors before plaintiff entered the picture. The reality of the transaction for tax purposes cannot be unilaterally determined solely by plaintiff's intent or motives. Breece Veneer and Panel Company v. Commissioners, supra, at 323. Thirdly, it is highly unlikely that the option will be exercised at the end of the first eleven years of the lease, after which time the building lease will generate a substantial taxable income to plaintiff. Finally, the fact that plaintiff will receive a tax benefit during the early years of the investment is in keeping with the intent of Congress to stimulate investments in depreciable real estate through accelerated depreciation deductions; it does not suggest that the substance of the transaction was not in keeping with its form. Plaintiff has the legal right to decrease the amount of what otherwise would be his taxes by means which the law permits. Gregory v. Helvering, 293 U.S. 465 at 469 (1935).

8. The agreement of Worthen, as lessee under the Building Lease, to pay all taxes, insurance and maintenance on the building, to hold the lessor harmless from all claims arising out of lessee's use of the premises and to pay rent during the initial term in an amount sufficient to amortize the mortgage on the building are all terms which are quite common in long-term real estate leases. Such assumption by Worthen of the risks of operation normally borne by an owner did not make Worthen the owner of the building for tax purposes.

9. All of the other terms of the agreements among the parties and the surrounding circumstances which defendant contends are collectively sufficient to make Worthen the owner of the building for tax purposes are common in and consistent with a bona fide sale-leaseback with option to purchase, and do not, individually or collectively, make Worthen the owner of the building for tax purposes.

Supplementary Findings of Fact and Conclusions of Law

In open court at the end of the trial and by Letter Memorandum of May 16, 1975, the Court made certain findings of fact and conclusions of law in this proceeding. In the Letter Memorandum of May 16, the Court indicated to the attorneys for the parties that it would "consider making additional factual findings and conclusions of law upon the request of either party if requests therefor are received by May 30, 1975." The plaintiff submitted "Proposed Findings of Fact and Conclusions of Law" prior to May 30, 1975. Defendant has submitted none.

Although the Court usually does not make findings with respect to uncontested or noncontroverted facts such as those contained in the "Proposed Findings of Fact" 1 through 7 and 10 through 13, it will supplement its findings of fact in this case by adopting said proposed findings since the facts stated are true and were never really at issue in the case. The Court has already made findings of fact in the matters referred to in "Proposed Findings" numbered 8 and 9. The proposed findings are accurate, but are simply a restatement of the facts previously found by the Court.

The "Proposed Conclusions of Law" submitted by the plaintiff are accurate statements insofar as they refer to the law involved, but most of the proposed additional conclusions are unnecessary in the light of the Court's rulings. The Court will, however, adopt "Proposed Conclusions" numbered 4, 6, 8 and 9 as supplements to, or a further statement of, its prior conclusions.

For the purpose of identifying the supplementary findings of fact and conclusions of law proposed by the plaintiff, the Court attaches hereto, and makes a part hereof, the submission by the plaintiff entitled "Proposed Findings of Fact and Conclusions of Law". [App. 3a-12a, *supra*.]

Judgment will be entered this date pursuant to the rulings in open court, the Letter Memorandum of May 16, 1975, and the findings of fact and conclusions of law adopted herein.

JUDGMENT

Findings of fact and conclusions of law having been entered in the above-styled case, judgment in conformity thereto is hereby entered in favor of plaintiff in the following amounts with interest thereon from the dates indicated:

$32,624.32 with interest thereon from March 15, 1969;
$231,871.26 with interest thereon from March 15, 1970;
$43,790.84 with interest thereon from April 19, 1973.

Dated this 11th day of June, 1975.

APPENDIX B

UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

No. 75-1615

FRANK LYON COMPANY, *Appellee*,

v.

UNITED STATES OF AMERICA, *Appellant*.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF ARKANSAS

Submitted: February 13, 1976.

Filed: May 26, 1976.

Before BRIGHT and HENLEY, *Circuit Judges*, and REGAN, *District Judge*.*

BRIGHT, *Circuit Judge*.

This income tax controversy arises from a series of complex documents which purport to effect a sale of a bank building (not including the underlying land) by a bank to taxpayer, Frank Lyon Company, and a 65-year leaseback with options to purchase the building by the bank. The question presented is whether these transactions vested taxpayer with ownership of the building for tax purposes so as to entitle taxpayer to deduct from its income the tax shelter benefits of depreciation of the building and interest paid on the building mortgage loan. The Commissioner of Internal Revenue ruled that taxpayer did not possess ownership of the building for tax purposes and denied taxpayer these tax advantages. Taxpayer paid the deficiency and successfully sued for a refund in the United States District Court for the Eastern District of Arkansas. The Government thereafter brought this appeal. We reverse, and sustain the Government's position.

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* JOHN K. REGAN, *United States District Judge, Eastern District of Missouri*, sitting by designation.

Taxpayer acquired its interest in the building in question from the Worthen Bank and Trust Company of Little Rock, Arkansas (Worthen). In 1965, Worthen entered negotiations for the purchase of land in downtown Little Rock on which to construct a new bank building. When such land was purchased, Worthen drew up plans for the new building and entered into construction contracts.

Worthen initially intended to finance the construction itself and to retain ownership of the building. However, federal and state banking regulations forbade Worthen to carry such an expensive building as an asset on its own books. Worthen thereupon decided to adopt a sale-leaseback arrangement using a newly-formed, wholly-owned corporate subsidiary to hold title to the building. However, Worthen learned that debt financing for such a subsidiary could not be arranged.

In 1967, Worthen informed banking authorities that it had decided upon a sale-leaseback arrangement with an independent investor. This approach satisfied the applicable state and federal banking regulatory agencies. Worthen then obtained a verbal commitment from First National City Bank of New York (FNCB) for interim construction financing. A similar commitment for long-term financing of the building was obtained from New York Life Insurance Company. The long-term financing was conditioned upon approval by New York Life of the party nominated by Worthen to hold title to the building.

Worthen then commenced arm-length negotiations with several investors. Taxpayer Frank Lyon Company learned of these negotiations and informed Worthen of its interest. Frank Lyon, chairman of the board of taxpayer company, served on Worthen's board of directors and Frank Lyon Company does substantial business with Worthen.

Worthen's proposal to the investors specified that construction would cost approximately $7,500,000. After some

negotiation, Worthen narrowed the field of potential investors down to taxpayer and one other party. Worthen then proposed that the investor selected should supply an ownership "equity" of $500,000, which would bear "interest" at the rate of six percent per year. The remaining financing would be supplied to the investor by the prearranged mortgage from New York Life at the rate of six and three-quarters percent, payable in 25 years. Worthen would lease back the building from the investor under the conditions discussed below and would retain an option to repurchase at the end of the 11th, 15th, 20th, and 25th years at specific amounts, plus an assumption of the New York Life mortgage. If Worthen did not purchase the building during the 25-year primary term, it would have eight additional options to extend the lease, each for a five-year period (40 years total). Worthen would agree to execute a 75-year ground lease for the land under the building (ownership of which Worthen retained) to the investor, and to subject the adjacent parking facility (of which Worthen also retained ownership) and certain building furnishings and equipment to the New York Life mortgage. Worthen retained the rights to the investment tax credit and sales tax savings generated by the building project.

Taxpayer was selected by Worthen as the investor when it agreed to accept these terms and additionally agreed to reduce Worthen's building lease payments by $21,000 per year for the first five years. It later developed that New York Life would not accept assignment of a lease incorporating this rental reduction. Worthen and taxpayer then entered a lease at the rental originally proposed but by separate agreement provided for some additional benefits to accrue to Worthen in an independent transaction.[1] There-

[1] When New York Life refused to accept assignment of a lease with such a provision, as a substitute taxpayer agreed in August of 1969 to pay a higher than normal rate of interest on a $500,000 loan obtained from Worthen which taxpayer used to buy out the

after, taxpayer, Worthen, First National City Bank, and New York Life Insurance Company entered into various leases, assignments, notes, and agreements effective May 1968 and December 1969, whereby Worthen "sold" its building as it was constructed to taxpayer and Worthen then "leased back" the building from the taxpayer.[2]

The ultimate sale price of the Worthen building to taxpayer amounted to $7,640,000, of which New York Life furnished all but $500,000 through its mortgage. This mortgage was secured by a first deed of trust executed by taxpayer and Worthen which conveyed to New York Life title to the land, building, and a parking facility. As additional security, taxpayer assigned to New York Life its interest in the building lease and ground lease. By separate agreement with New York Life, Worthen consented to this assignment and agreed not to terminate the building lease as long as the mortgage remained outstanding.

Worthen's annual rent for the first 25 years of the building lease represents the exact amount necessary to fully

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shareholders of a Coca Cola Company. Taxpayer paid an interest rate three percent greater than its usual borrowing rate from Worthen. This one-year note has been renewed from time to time up to the date of trial without reduction of the principal.

[2] Worthen contracted for the building and supervised its construction. As construction progressed, Worthen transferred its interest in the building to taxpayer piecemeal so that the building never appeared as an asset on Worthen's books. The construction cost was paid by FNCB, the interim mortgagee, pursuant to an interim financing agreement between FNCB, Worthen, and taxpayer, in which Worthen conveyed title to the building, land, and banking facility to the lender, and taxpayer assigned its interest in the ground lease and building lease to FNCB as additional security for the loan. Worthen also guaranteed that the building and parking facility would be fully completed, free from liens, by December 1, 1969, and that if the construction loan had not been paid (through closing of the mortgage with New York Life) Worthen and taxpayer would enter into a new building lease on terms satisfactory to FNCB.

amortize the 25-year, $7,140,000 New York Life mortgage.[3] Should Worthen exercise its option to purchase during the primary term of 25 years, taxpayer would receive a net cash amount equal to its $500,000 "equity" investment plus six percent compounded interest. Should Worthen elect not to purchase the building and to continue paying rent for the potential additional 40-year life of the lease (eight extensions of five years), the rental payments provided will approach but not equal taxpayer's $500,000 investment compounded at a six percent rate.[4]

As we have already noted, Worthen retains an option to repurchase the building at the end of 11, 15, 20, and 25 years at the exact amount of taxpayer's investment of $500,000 in the transaction, compounded at six percent per

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[3] The rental owed by taxpayer to Worthen for the ground lease during the 25-year primary term amounts to the nominal sum of $50 per year. All parties are agreed that ground rents constitute a "wash" item since greater ground rents would call for an increased building rental to be paid by Worthen. However, after the first 25 years, the ground rents sharply increase to $100,000 per year starting in 1994, $150,000 in 1999, $200,000 per year in 2004, and $250,000 for the next 25 years to 2034. At the same time, the building lease rentals inexplicably become approximately halved to $30,000 per year. The ground lease is for a term of approximately 10 years longer than the 65-year building lease. During this last 10 years, the annual ground rent is set at $10,000. Should Worthen continue to occupy the building during this period, a new building lease and rental would have to be negotiated with taxpayer.

[4] As we have observed in note 3 *supra*, if the lease runs its full term, the taxpayer could negotiate a new lease for the building during the additional 10 years covered by the ground lease. Depending upon the rentals, the taxpayer could assure receipt of its original investment and the interest compounded thereon for the full 75-year period covered by the ground lease.

Taxpayer vehemently argues that Worthen will extend the lease to the full 65-year term. The Government argues that Worthen will exercise its purchase option.

annum, plus assumption of the unpaid balance of the New York Life mortgage. We observe in this connection that the first option period occurs after the first 11 years of the lease during which income tax savings to taxpayer from interest and depreciation will amount to about $1,500,000. Thereafter, taxpayer would reap no tax benefits from ownership. Increasing amounts of the rental received from Worthen and passed on to New York Life would apply to the principal of the mortgage rather than to interest, and hence would not be deductible. At the same time, allowable depreciation on the building would not equal the non-interest portion of the rent. The net result would be taxable income to taxpayer.

The various terms of the lease provide that essentially all costs, risks, and responsibilities rest with Worthen. For example, Worthen bears all repair and maintenance expense, all public utility charges, mechanics' liens, taxes and levies of every sort, and all insurance expenses, including property, liability, fire, war risk, and sprinkler and boiler damage. Worthen also must indemnify the lessor for any claim arising out of the operation of the building and repair any damage of destruction. By the terms of the lease, the rent is absolutely net to the taxpayer (and hence to New York Life) without allowance for any counterclaim, setoff, or defense by the lessee, and is to be paid without notice, demand, counterclaim, setoff, or defense lessee might otherwise assert.

Worthen's obligation to make payment of rent to taxpayer is not affected by any damage or destruction to the building. Interestingly, any condemnation or insurance proceeds resulting from total destruction apply in the following order: (1) to New York Life in an amount sufficient to fully prepay the mortage; (2) the balance to taxpayer up to the amount provided as the purchase price in the termination table (amortizing taxpayer's $500,000 investment at six percent); and (3) any excess to Worthen.

Worthen has the option to either replace the building or to purchase it in the event there is a partial condemnation or total destruction on or after December 1, 1980.[5]

On taxpayer's corporate income tax return for 1969, taxpayer reported the payments by Worthen under the building lease as rental income, and claimed deductions for depreciation on the Worthen building, interest paid on the interim and permanent mortgage loans, and other expenses it had borne with respect to the contruction of the building. Upon audit of the taxpayer's return for 1969, the Commissioner determined that for federal tax purposes the taxpayer was not the owner of the Worthen building, but that the real ownership in the building as a matter of economic substance was retained by Worthen. The Commissioner's notice of deficiency denied taxpayer's claimed deduction for depreciation, interest, and other expenses with respect to the construction of the buliding but eliminated the rental income reported by taxpayer for the lease of the building. Taxpayer thereafter paid the deficiency, filed a claim for refund, and upon its denial, brought the instant action. As previously noted, the district court granted relief.

Although the court made findings of fact, the essence of its holding is expressed in the court's unreported letter opinion of May 16, 1975, as follows:

> [T]he Court finds that it was the intention of the parties, as evidenced by their written agreements, read in the light of the attending facts and circumstances existing at the time the agreement was executed, that the transaction be exactly what the language and form

[5] The bank also reserved a right (by way of a separate letter agreement) to purchase the building at fair market value in the event of insolvency of the taxpayer or if the ownership of taxpayer company changes to others from that of Frank Lyon, his heirs, or his current working associates.

> of the transaction indicate, that is, a sale-leaseback with option to repurchase. This was both the "subjective" intent of the parties, and it is also the "objective" intent as expressed by the clear, unambiguous language of the written instruments involved. The Court also finds and concludes that, objectively, the transaction was in substance, as well as in form, a sales-leaseback with option to repurchase.

The taxpayer emphasizes that the trial court's findings of intent resolve a question of fact and bind us on appeal unless "clearly erroneous". Taxpayer points to our prior ruling that

> where the true nature of payments made under a lease-purchase instrument is drawn into question in tax cases, it is necessary to ascertain what the parties intended. [*Western Contracting Corp.* v. *Commissioner*, 271 F.2d 694, 699 (8th Cir. 1959).]

Numerous other cases support the view that intent is an important consideration. *See American Realty Trust* v. *United States*, 498 F.2d 1194 (4th Cir. 1974); *Breece Veneer & Panel Co.* v. *Commissioner*, 232 F.2d 319 (7th Cir. 1956); *Benton* v. *Commissioner*, 197 F.2d 745 (5th Cir. 1952). The Government responds that the ultimate question of ownership of property as it affects taxability rests upon a substantially undisputed record and must be reviewed as a question of law. *See American Nat. Bank of Austin* v. *United States*, 421 F.2d 442, 451 (5th Cir.), *cert. denied*, 400 U.S. 819 (1970); *Union Planters Nat. Bank of Memphis* v. *United States*, 426 F.2d 115 (6th Cir.), *cert. denied*, 400 U.S. 827 (1970).

Both parties' positions are partially correct. It is our duty to ascertain the economic substance of transactions in order to determine their characterization for tax purposes. *Helvering* v. *F. & R. Lazarus & Co.*, 308 U.S. 252 (1939). Since parties are generally free to dispose of property interests as they wish, the substance of a transaction usually derives from the parties' intent. Subject to certain policy considerations, the courts will respect the actual allocation of interests made by the parties even though it reduces or eliminates tax liability. *Helvering* v. *F. & R. Lazarus & Co.*, *supra*; *Gregory* v. *Helvering*, 293 U.S. 465 (1935).

In major transactions, the intent of the parties is usually spelled out in written form. Where the documents embodying the transaction are clear and complete, the court is called upon to interpret the documents, and from their substance, to characterize the transaction for tax purposes as a matter of law. *See American Nat. Bank* v. *United States*, 421 F.2d 442 (5th Cir. 1969), *cert. denied*, 400 U.S. 819 (1970). However, where the documents are ambiguous or incomplete, the court must first ascertain the unexpressed subjective intent of the parties in order to properly interpret the agreement and thus disclose its substance. *See* and *compare Helvering* v. *F. & R. Lazarus & Co.*, *supra*; *Western Contracting Corp.* v. *Commissioner*, *supra*; *Benton* v. *Commissioner*, *supra*.

The court's determination of the parties' unexpressed subjective intent is a finding of fact. This inquiry may be assisted by the labels such as "lease" or "sale" which the parties have used in describing the transaction, but other factors are also significant and sometimes controlling. However ascertained, this subjective intent is of importance only to the extent that it affects the actual allocation of interests, not in spite of that allocation. We made this clear in *Western Contracting Corp.* v. *Commissioner*, *supra*, where we said the following:

> If the parties enter into a transaction which they honestly believe to be a lease but which in actuality

> has all the elements of a contract of sale, it is a contract of sale and not a lease no matter what they call it or how they treat it on their books. [*Id.* at 699; *quoting Oesterreich* v. *Commissioner*, 226 F.2d 798, 809 (9th Cir. 1955).]

In this case the allocation of interests between parties is spelled out in undisputed written documents. Characterization of the transaction for tax purposes requires us to "reason and interpret" these documents. *American Nat. Bank* v. *United States*, 421 F.2d 442, 451 (5th Cir. 1970). As the Fifth Circuit said, this "is the law obligation of the courts as distinguished from its fact finding duties". *Id.*, *quoting United States* v. *Winthrop*, 417 F.2d 905 (5th Cir. 1969).

We examine the issue of ownership by examining the respective rights held by the parties. In the common law sense, property rights can be analogized to a bundle of sticks. Each stick represents an interest in the underlying *res* which is the object of property. Certain commonly occuring bundles have been given conventional "labels" such as "lease" or "license". Frequently, the express agreement of the parties to a transaction will not specify the allocation of each stick. In such a case, the fact that the parties choose a particular label such as "lease" to describe the transaction may be a reliable guide to the allocation of sticks intended, although other indications of intent may modify or even supersede the labels employed. The determination of who got which bundle of sticks may require a determination of subjective intent and thus a preliminary finding of fact. However, except to the extent that subjective intent affects the allocation of the sticks, it is simply immaterial to the characterization of the transaction for tax purposes. Once the contents of each bundle is found, its tax characterization is strictly a question of law independently reviewable on appeal.

In this case the Government concedes that all parties intended to apply the label "sale-leaseback" to the transaction. However, the Government contends that this label has no real-world significance because every meaningful interest in the building was clearly possessed by Worthen by the agreement of the parties. In essence, the Government alleges that taxpayer totes an empty bundle and that the term "owner" for tax purposes cannot reasonably be attached to the empty wrapping taxpayer has retained.

Taxpayer responds that it cannot be assumed that Worthen will exercise its option to purchase and thereby reimburse taxpayer for its initial $500,000 investment plus accrued interest. Taxpayer further argues that if the purchase options are never exercised, it will eventually suffer the economic loss of depreciation and obsolescence of the building.

It is at this point that the ultimate issue is joined. The question for this court is whether, giving due deference to the underlying factual determinations of the district court, the taxpayer has demonstrated that it possesses sufficient genuine interests in the property to establish its legal right to be considered the owner for tax purposes. To resolve this question, we turn to the documents and undisputed testimony which establish the following allocation among the contracting parties of the benefits and burdens generated by the building.

1. Although mortgage monies and the half-million dollar contribution from the taxpayer covered the construction cost of the building, Worthen retained for itself the tax deduction for investment credit and sales taxes paid upon the materials which were purchased incident to the building's construction.

2. The lease agreements carefully circumscribed the usual right of an owner to obtain a profit from his investment by transferring his interest to a third party. Here,

Worthen insisted upon a letter agreement from Frank Lyon Company giving Worthen the right to purchase the building in the event of a transfer of ownership of the Frank Lyon Company to anyone other than Mr. Lyon, his immediate heirs, and his current working associates in the taxpayer-company. Although the letter agreement provided for a negotiated price, any such price would obviously be related to Worthen's long-term lease (which generates no cash flow) and options to purchase the building after 11, 15, 20, or 25 years for $500,000, plus six percent compounded interest on that amount, and the unpaid balance of the underlying building mortgage to New York Life.

3. Any appreciation in value of the building realized as the result of its destruction or condemnation accrues to Worthen and not taxpayer.

4. The parties geared the purchase-option price to the unpaid balance on the mortgage plus taxpayer's initial investment plus interest accrued thereon at the limited rate of six percent per annum compounded. The parties took no account of likely appreciation in the value of the building nor inflationary factors, the latter an almost constant factor in economics for the past 40 years, nor otherwise provided for purchase at a future appraised valuation of the building. The rental payments over the first 25 years of the lease reduce the purchase price dollar for dollar. By contrast, the parties apparently recognized the likely appreciation in land values by almost doubling the ground rents upon satisfaction of the mortgage.

5. The final option price at the end of the initial 25-year term on November 30, 1955, in the sum of $2,145,935, reflects taxpayer's initial investment plus compounded interest thereon over these years. At that time the present value of the future net rentals for the next 40 years, discounted at six percent, would approximate the taxpayer's original half-million dollar investment plus the compounded interest accrued to that date. Although this amount does

not fully amortize taxpayer's investment at six percent interest, the taxpayer is left with an additional ground lease for 10 years at only $10,000 per year with the right to negotiate with the bank or a new tenant for additional lease payments for the use of the building for the further period of 10 years. Thus, the taxpayer is given an opportunity to recoup his full investment at six percent interest prior to expiration of the ground lease.

6. The bank retained ultimate control over the disposition of the building through its various options for 65 years and its ownership thereafter of the land upon which the building rested.[6]

7. Finally, during the initial 25 years, the bank retained exclusive power to dispose of the building through its option privileges. During this period the taxpayer merely serves as a conduit for the lease payments to be transmitted to the mortgagee to pay the mortgage indebtedness. All responsibilities incident to the operation and ownership of the building otherwise rest with the bank. The only economic advantages inuring to taxpayer during this period are tax

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[6] The Government contends that under Arkansas law, Worthen will achieve absolute ownership of the building at the expiration of the ground lease. *Williams* v. *Kirby School Dist. No. 32*, 181 S.W.2d 488, 490 (Ark. 1944); *Wilson* v. *Davis*, 153 S.W.2d 171 (Ark. 1941). Taxpayer cites an 1878 case, *Sterman* v. *Cravens*, 33 Ark. 376 (1878), for the proposition that title to a building does not pass to the owner of the land upon the expiration of the lease unless the lease so provides. Worthen argues that if the parties cannot agree upon a subsequent lease or repurchase of the property between themselves, an Arkansas court of equity will order the sale of the land and building together and divide the proceeds in proportion to the respective value of the land and building. We need not resolve this issue except to note that the retention of the land reserved to Worthen substantial control over the ultimate disposition of the building should the bank forego its option privileges. Taxpayer's dubious claim to some form of equitable adjustment 75 years in the future does not substantially alter this conclusion.

shelter benefits worth one and one-half million dollars in tax savings to the taxpayer during the first 11 years (if it should be considered owner), plus a nominal return on its investment of six percent compounded annually. The contract provides for no return related to ownership risk.

We do not doubt that the Worthen bank drove a hard bargain. It suffered no significant economic detriment by allegedly not owning the building since it asserted the right to deduct lease payments from current income. Nor did the terms of the lease deprive it of any significant benefit of ownership. However, the lease did satisfy the technical requirements of the banking regulations. By contrast, the taxpayer seeks to be considered as the owner for the sole purpose of reaping a benefit from the tax laws of the United States which allow an owner of property to deduct both depreciation of an asset and interest payments upon the purchase mortgage.

The overall nature of this transaction is closely akin to that in *Helvering* v. *F. & R. Lazarus & Co., supra.* There the taxpayer was the seller-lessee, occupying essentially the same position as Worthen in the present case. The taxpayer had assigned title to two properties and a 99-year lease to a third to a bank and at the same time had leased the properties back for 99 years with an option to renew the lease and to purchase the properties. The Supreme Court affirmed the judgmment of the tax court which found that the taxpayer was the real owner of the properties. The Court characterized the bank's interest as an owner-lessor as essentially that of a mortgagee. It held that "[i]n the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding." *Id.* at 255. Nothing in the Court's opinion places any emphasis on the parties' desired characterization of the transaction for tax purposes.

The Government also points to the tax treatment afforded the taxpayers in *Commissioner* v. *H. F. Neighbors R. Co.*, 81 F.2d 173 (6th Cir. 1936), and *Frito-Lay, Inc.* v. *United States*, 209 F. Supp. 886 (N.D. Ga. 1962). Taxpayer here attempts to distinguish those cases factually and takes comfort in their language which places some emphasis upon the parties' intent. However, the intent found by the courts in those cases accorded with and contributed to the economic substance of the transactions. For example, in *Frito-Lay*, the court expressly stated that the intent of the parties was a "guide" to the true nature of the transaction, 209 F. Supp. at 891, not a component thereof.

In this case, as we have already held, the asserted "intent" to effect a sale-leaseback for tax purposes is not a guide to the economic substance of the transaction, but instead appears to be wholly unrelated to the actual allocation of interests. Taxpayer's reliance upon *American Realty Trust* v. *United States*, 498 F.2d 1194 (4th Cir. 1974), is misplaced. The arrangement there was not nearly so thin and transparent as the present transaction.

In sum, the benefits, risks, and burdens which taxpayer has incurred with respect to the Worthen building are simply too insubstantial to establish a claim to the status of owner for tax purposes. Taxpayer's claim to a depreciation allowance as owner of the Worthen building must be disallowed.

The interest deduction here also turns upon the ownership of the building. The record is clear that the real security for the mortgage is the building and the party with the real interest in maintaining the mortgage payments is Worthen. In effect, we sustain the Government's position that taxpayer served as a mere conduit for the mortgage payments made by Worthen to New York Life. The Commissioner properly did not charge taxpayer with rental income in the receipt and transmission of these funds.

In closing, we note what our opinion does not do. First, what we have said relates only to the tax status of the Frank Lyon Company. Worthen is not a party to this appeal. Our opinion in no way affects Worthen's relationship to the Worthen building, as recognized by federal and state banking regulations.

Second, our opinion should not be read as a general condemnation of sale-leaseback arrangements. They are an accepted and useful means of controlling business property. As taxpayer argues, many of the features of the lease in this case have been held not to terminate tax ownership when viewed independently. The vice of the present lease is that all of these features have been employed in the same transaction with the cumulative effect of depriving the taxpayer of any significant ownership interest.

Accordingly, we reverse the judgment of the district court and remand this case for the entry of judgment against the taxpayer consistent with this opinion.

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

September Term, 1975

No. 75-1615

FRANK LYON COMPANY, *Appellee*,

v.

THE UNITED STATES OF AMERICA, *Appellant*.

(Filed May 26, 1976)

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF ARKANSAS

Judgment

This CAUSE came on to be heard on the record from the United States District Court for the Eastern District of Arkansas and was argued by counsel.

On CONSIDERATION WHEREOF, it is now here ordered and adjudged by this Court, that the judgment of the said District Court, in this cause, be, and the same is hereby reversed.

A true copy.

ATTEST:

/s/ ROBERT C. TUCKER

Clerk, U. S. Court of Appeals, 8th Circuit.

APPENDIX D

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 75-1615

FRANK LYON COMPANY, *Appellee*,

v.

UNITED STATES OF AMERICA, *Appellant*.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF ARKANSAS.

Filed: August 6, 1976

Before BRIGHT and HENLEY, *Circuit Judges*, and REGAN, *District Judge*.*

Order

Appellant Frank Lyon Company has filed a petition for rehearing with a suggestion for rehearing *en banc*. The petition requests this court to determine the tax status of appellant's $500,000 investment in the Worthen building and to resolve the issue of the deductibility of interim interest and other expenses incurred by taxpayer.

While those issues were encompassed in the litigation, the precise matters referred to in the petition were neither the subjects of specific rulings by the district court nor were they briefed or argued in this court. Thus, they were not addressed in our opinion. We intend that those issues not disposed of by our opinion be resolved by the district court on remand, upon application of the parties should they fail to reach agreement. To clarify our intent, we

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* JOHN K. REGAN, *District Judge, Eastern District of Missouri*, sitting by designation.

direct that the final paragraph of our opinion be modified as follows:

> Accordingly, we reverse the judgment of the district court and remand this case for the entry of an appropriate judgment not inconsistent with this opinion.

With the exception of this clarification, the petition of Frank Lyon Company is denied.